THE FIRST TIME YOU NEVER FORGET: THE SUCCESS OF BRAZIL IN THE 2009 CRISIS AND THE NEED FOR THIRD-GENERATION REFORMS

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Understanding how Brazil successfully faced the 2009 global crisis is interesting because the country is currently the 10th largest economy in the world and should climb new positions in that ranking in the years ahead. The recession lasted only two quarters in Brazil, followed by the creation of a million new jobs in 2009 and the expectation of 7 per cent GDP growth in 2010. For the first time in many years, instead of getting pneumonia when the rest of the world got a cold, Brazil fared better than most countries. This paper argues that this was the result of many years of accumulating strength through fiscal discipline and structural reforms, together with special features of the present crisis. The text, written from a practitioner stand point, summarizes the response of the Brazilian government to the crisis, highlighting factors that may help explain its success and the risks ahead. It also reviews options to leverage structural factors favoring growth in the coming years and the much yearned reduction in interest rates. It argues that priority should be given to keep fiscal responsibility and promote third-generation reforms to, inter alia, better use the excellent financial infrastructure that already exists in Brazil to fund much needed investments.

1 Introduction

The impact of the 2008 financial crisis was short-lived in Brazil. As several developing economies continued to grow well after the US economy started to cool down in 2007. That apparent decoupling with the US and Europe resumed after a quick contraction following the failure of Lehman Brothers. GDP dropped 1.9 per cent in each quarter in early 2009, but seasonally-adjusted activity had overcome the peak of 2008 by the end of 2009, resulting in –0.2 per cent change in average GDP that year and expected growth in 2010 above 7 per cent (Figure 1). The two-quarter recession in 2009 followed 21 quarters of uninterrupted growth and was the shortest cycle in the last 30 years, although also the deepest.

Figure 1

Real GDP

(chained index 1995=100)

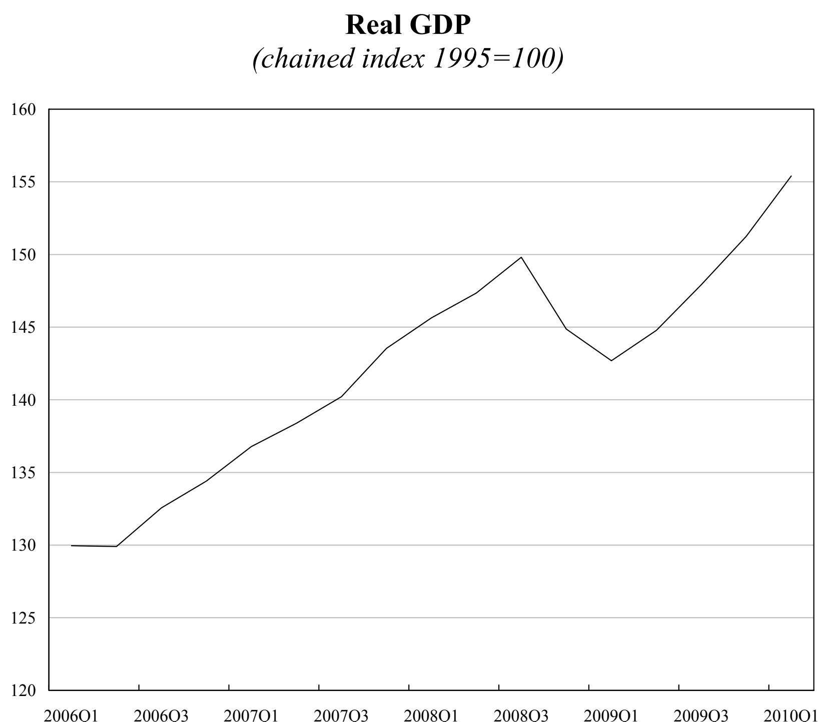

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Table 1

Labor Turnover at the Formal Market in 2009

Branch	Admissions	Dismissions	Net	Percent of Change
Farming	1,270,867	1,286,236	–15,369	–0.99
Mining	42,915	40,879	2,036	1.18
Industry	3,147,085	3,136,220	10,865	0.15
Utilities	77,608	72,624	4,984	1.41
Construction	1,950,078	1,772,893	177,185	9.17
Commerce	3,783,528	3,486,371	297,157	4.20
Services	5,802,755	5,302,578	500,177	3.93
Public sector	112,804	94,729	18,075	2.33
Total	16,187,640	15,192,530	995,110	3.11

Source: CAGED – Ministry of Labor.

Almost one million new formal jobs were created in the twelve months to December 2009. Job creation was positive in all sectors except for farming. Also the informal sector accompanied the formal market, further brightening the labor market (Table 1). Job creation in 2010 is likely to exceed 2 million positions.

Understanding how Brazil overcame the crisis so quickly is interesting because Brazil is already the 10th largest economy and may become the 5th largest in the next few years. The economy was much more resilient this time than in any previous occasion in the last 25 years, and the government had instruments to react to the crisis. Therefore, as soon as it became evident that the world economic meltdown had been averted by vigorous government intervention in developed countries, the Brazilian economy reacted, also helped by confidence from foreign investors. This was translated into an economic boom, with the acceleration of infrastructure investment, and evidence that emerging markets could make a contribution to the world economic recovery.

The response of the government, made possible by the strengthening of the economy in recent years, provides a useful background to the discussion of priorities for the upcoming period. Government response, although timely and effective, implied an increased exposure of the public sector to the balance sheet of companies and was accompanied by a deterioration of the external current account balance. The impact of these risks is still limited and mitigated by several factors, such as the new oil province announced in 2008 that will provide long-term support to Brazilian exports. These favorable factors do not overshadow, however, the need for further structural reforms, especially to attain the goal of reducing distortions that still keep interest rates at high levels, and to allow the private sector to grow with less support from government. The following sections of this text review the reforms undertaken in the last 15 years and the economic standing of the Brazilian economy before the crisis, as well as the response of the government to the crisis, to sketch a balance of risks ahead and policy options to help attain the objectives above.

2 Initial conditions

2.1 The 1990s

Brazil has experienced important changes in the last twenty years. These changes were spearheaded by the opening of the economy in 1990, in the wake of the fall of the Berlin Wall. Because inflation of more than 1000 per cent made impossible for Brazil to be competitive in a global economy, that opening forced the government to face the problem of chronic inflation, which had worsened in the 1980s. For this purpose, a clever mechanism was implemented in 1994 to stop inflation protecting the economic value of existing contracts. The underlying conditions to this transformation were a fiscal contraction in 1993-94 and increased access to external savings in 1995-97. The end of inflation also forced the consolidation of the financial sector and spurred a modern and comprehensive financial regulation, higher bank capitalization, and enhanced supervision.

Globalization helped anchor the new currency during the mid 1990s and finance long overdue investments, notably in infrastructure. In this environment, profound changes in the business sector, now facing full fledged foreign competition, fostered an increase in overall productivity. Tight monetary police, on the other hand, stimulated the maintenance of low leverage ratios, helping insulate companies from international crises.

Low inflation, however, posed a fiscal challenge. The loss of the inflation tax, combined with wage increases granted in the last months of high inflation proved a heavy burden to state governments and the federal government, and herald a few years of fiscal relaxation. The persistence of high interest rates, reflecting a lingering distrust about fiscal sustainability and the overall macroeconomic balance, further punished public accounts. As a consequence, the public sector was vulnerable to the Asian crisis, and particularly to the events following the failure of LTCM and events related to the Russian debt in 1998. Increased risk aversion by international investors rendered difficult to keep the pegging of the *real*. The strategy of trying to stem capital outflows through higher domestic interest rates quickly showed its limitations, stressed the fiscal outlook and ultimately led to the breakdown of the exchange rate system in early 1999.

The response of Brazil to the 1998 crisis was a new macroeconomic framework based on a flexible exchange rate, inflation targeting, and fiscal responsibility. Of these, the most difficult to achieve, as well as the most important, was a long overdue commitment to fiscal discipline. The new framework was introduced amid an unfavorable international environment, and against the initial skepticism of the International Monetary Fund, but has been long-lived and successful.

2.2 The 2000s

Fiscal discipline was quickly translated into the Fiscal Responsibility Law voted in 2000. The law provided an encompassing framework, applicable to the federal, state and local government. The Fiscal Responsibility Law-LRF, in addition to introduce sharp constraints on the financing of the public sector, including state-controlled financial institutions, provided for budgetary planning and disclosure rules. A hallmark of the LRF is the bi-monthly review of fiscal targets and budget execution, which drastically reduces the chance of large slippages. The law also rendered unlawful the bailing out of states by the federal government. It provided for limits to public debt, which reinforced those set in refinancing programs signed by the federal government and states in the late 1990s. A comprehensive and swiping electronic system was built to check the compliance of government to obligations, halting voluntary transfers when rules are not observed. Importantly, fiscal dominance was reduced by the focus on primary fiscal targets, rather than on nominal fiscal

Table 2

Federal External Debt in 2008
(million US$ equivalent)

Maturity	Dollar	Euro	Real	Other	Total	Share
in 12 months	4,025.76	855.67	552.27	133.08	5,566.77	5.78%
in 24 months	9,262.84	1,882.36	1,104.53	221.79	12,471.52	12.95%
in 36 months	14,997.21	2,762.82	1,944.26	286.04	19,990.32	20.75%
in 48 months	19,749.91	3,492.55	2,640.23	339.28	26,221.97	27.22%
in 60 months	24,732.04	4,257.52	3,369.80	395.10	32,754.45	34.01%
beyond 5 years	48,480.20	7,443.70	7,099.29	543.14	63,566.33	65.99%
Total	73,212.24	11,701.21	10,469.09	938.24	96,320.78	100.00%

targets. This choice helped improve overall fiscal planning and relieved the pressure on monetary policy, strengthening its ability to deliver the inflation targets.

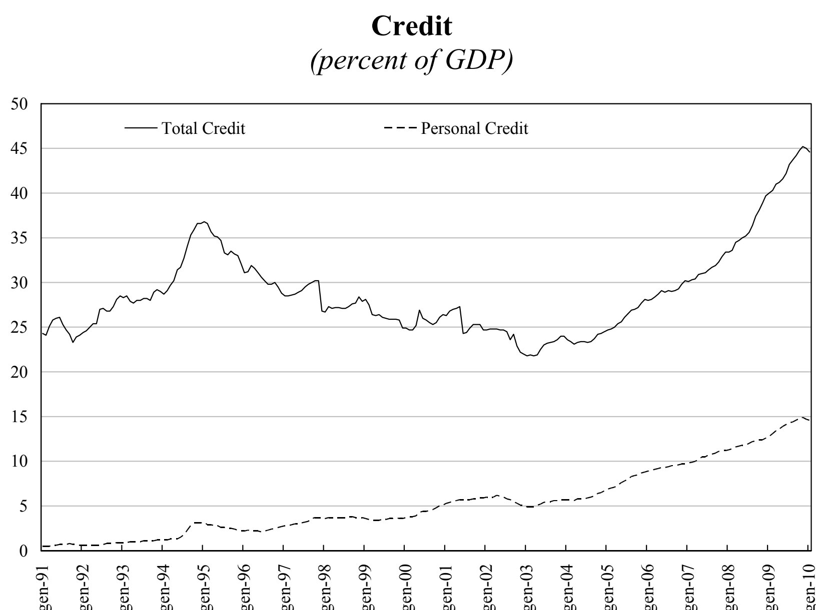
Fiscal targets were met every year to 2009. Moreover, in the wake of the election of President Lula, the target for the consolidated public primary surplus was raised to 4.5 per cent of GDP, a value observed in the following years. Unfortunately, the brunt of the fiscal adjustment fell on tax increases, owing to the rigidity of pensions and health care, as well as of public wages. As a consequence, the tax-to-GDP ratio for the consolidated public sector rose from around 25 per cent in the early 1990s, to around 35 per cent by the mid of the 2000s.

Improvements in the fiscal stance helped change the profile of public foreign debt after 2003. Old, expensive Brady bonds issued in the 1990s were replaced by cheaper and longer-term global issues; for the first time ever *real*-denominated bonds were issued abroad, as a way to familiarize a new class of investor to the local currency and eventually to local bonds. In 2005, all IMF loans were repaid in advance, the same happening to Paris Club loans, some of which dating back from the 1980s. The stock of foreign public debt was lengthened, with 2/3 of maturities beyond five years, and had dropped to US$ 96 billion by 2008 (Table 2). These improvements were translated into a much belated upgrade of the foreign federal debt to "investment grade" in 2008.

The floating exchange rate, together with the worldwide dynamism of international trade, spurred Brazilian exports. Since 2000, the diversification of products as well as of destinations of Brazilian exports has been remarkable, with manufactures reaching an increasing large array of partner countries. Brazilian companies also expanded abroad, with acquisitions and contract awards in all continents. As a result, Brazilian exports jumped from about US$ 50 billion in 2000 to close to US$ 200 billion in 2008. Between 2004 and 2007, Brazil also ran a small current account surplus, allowing the Central Bank to accumulate reserves on a more solid fashion than in the 1990s.

Improvement in the fiscal and external balances promoted confidence and GDP growth. After a major turbulence ahead of President Lula election in 2002, a long period of growth took hold, further buttressed by the President's steadfast support of the Central Bank. After almost two decades, average growth was back in excess of 4 per cent, notwithstanding the forceful response of the Central Bank anytime high growth (e.g., 5.7 per cent in 2004) started to build inflation

Figure 2



pressures. The improvement in the denominator of the debt/GDP ratio reinforced the contribution of the real appreciation and of interest rates, to reduce this ratio by almost 10 percentage points in 2003-08.

Growth was accompanied by more domestic credit. While the domestic credit/GDP ratio had dropped from 35 in 1995 to 22 per cent in 2002, it showed a steady increase in the following years, rising from 23.5 in 2004 to 37 per cent by late 2008 (Figure 2). That growth was due mostly to private banks, in the wake of lower spreads and reforms that yielded stronger guarantees and liens over paychecks, cars and residences.

Credit and jobs helped create a new middle class. Poverty reduction, which improved significantly after the stabilization of the currency in 1994, was accelerated after 2005. Although the Gini coefficient remains high at 0.57, strong job creation, as well as transfer programs such as the Bolsa Família that benefits 12 million households, have contributed to reduce the number of very poor households (income below R$ 804) by 40 per cent since 2002 (Figure 3). Meanwhile, the share of the middle class, *i.e.*, households earning between R$ 1,150 and R$ 4,800 a month (US$ 8,500-32,500 a year), in the population has risen by more than 10 percentage points. Together with the upper classes, it accounts now for 70 per cent of households, from 53 per cent in 2003.[1] The impact of income growth on consumption has been further fueled by more personal credit, especially paycheck loans, with strong reflex on the consumption of services and durable goods.

In sum, in mid 2008 Brazil enjoyed a growing economy, with a comfortable external balance, a much improved fiscal situation, and a watchful Central Bank. The country also experienced a surge in investment, reflected in a record number of IPOs. Fortunately, all these indicators, including credit, were still in a beginning-of-a-cycle position when the crisis hit.

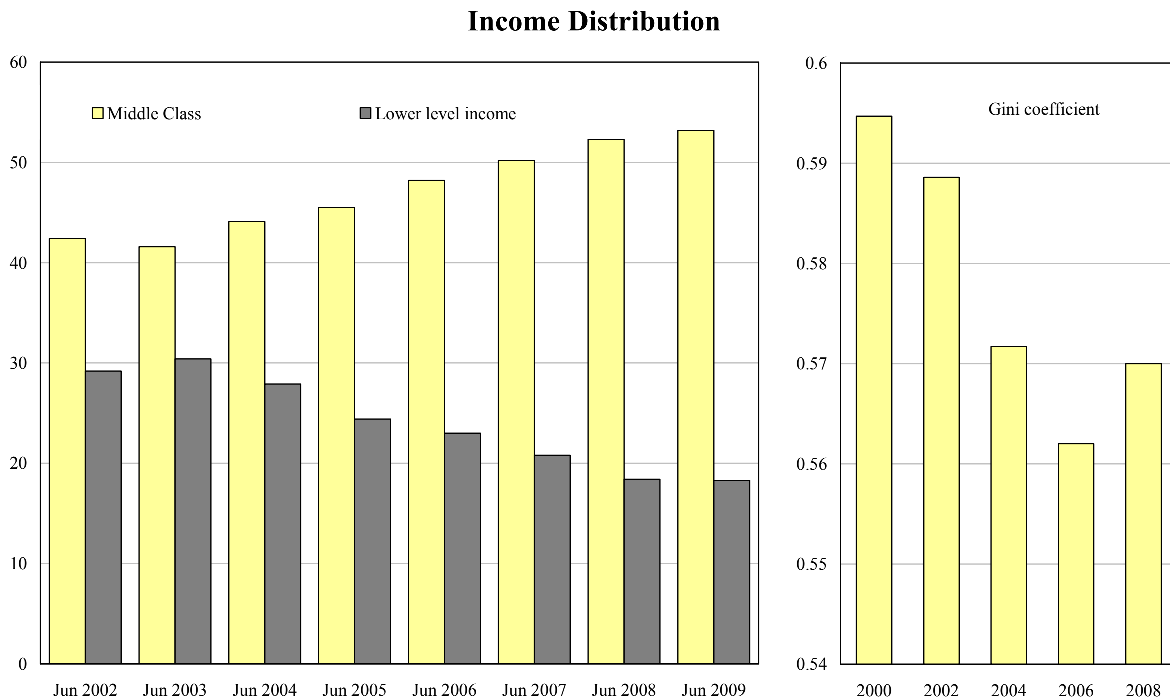
3 The crisis and the government response

The credit crunch and drop in commodity prices that are typically caused by financial crises was very brief in the aftermath of the failure of Lehman Brothers. The crisis initiated in 2008 was different from the ordinary global shock, because of the response of authorities in developed countries and China. This time around, there was a massive injection of liquidity by the central banks of developed countries and China helped keep world demand afloat by embarking in a

[1] Ranking established by the Center for Social Policies at Fundação Getúlio Vargas.

Figure 3

Income Distribution



massive public works program. Both features created a favorable environment to Brazil. Together with the soundness of the Brazilian financial market and the Central Bank ability to respond to circumstances without wavering in its commitment to the floating exchange rate, this environment helped business people to quickly recover confidence and the government to use the fiscal room it had build, without jolting financial markets. In the occasion, the Central Bank also reinforced its vast international reserves with contingent lines with the US FED (US$ 30 billion) and the IMF. None of these lines were however used.

The government response to the global slowdown can be grouped into protection of financial markets and support to credit; full use of automatic stabilizers; and outright fiscal stimulus. The Central Bank played a paramount role in implementing the first group, while policies already in place responded for most of the second, and a mix of tax brakes, public-sector wage increases, and a pro-active stance of public banks accounted for the third. The ability of the country in successfully deploying theses tools, rather than their originality, was perhaps the big news about them.

3.1 Protection of financial markets

The Central Bank ensured the smooth operation of currency markets. This was based on more than US$ 200 billion in international reserves, and the judicious swap of part of them with domestic players. Central Bank interventions included US$ 24 billion in credit to exporters, outright sales of US$ 14.5 billion and swaps adding to US$ 33 billion (Table 3). This strategy was predicated on the view that the external sector was fundamentally sound, and those who had borrowed from the Central Bank would be able to repay it in a few months. The provision of liquidity ensured that exports continued to flow, and that futures markets would not face undue turbulence; also the Central Bank could earn some income by selling dollars when the *real* was

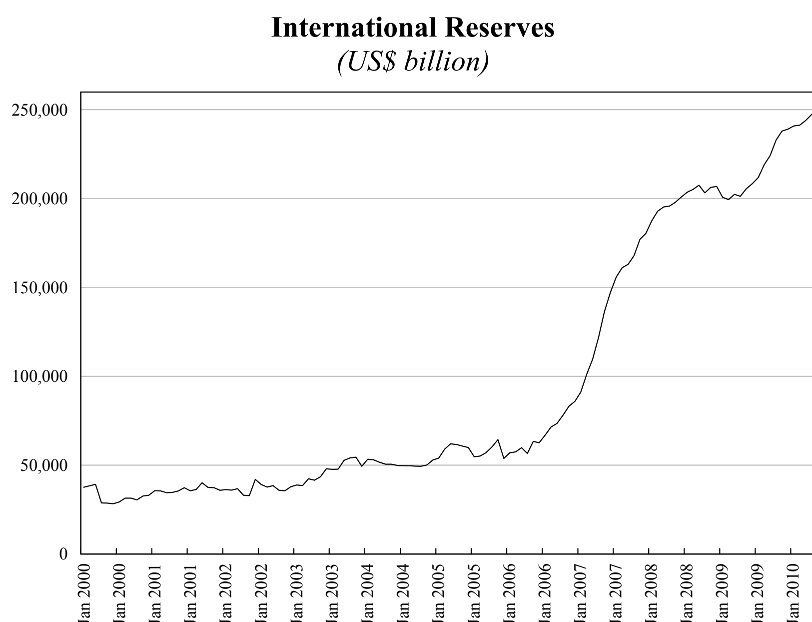
Table 3

Interventions of the Central Bank in Late 2008 and Accumulation of Reserves to July 30, 2009
(US$ billion)

Item	Sales	Repayments	Balance
Spot	14.5	8.2	6.3
Export financing + repos	24.5	20.0	4.5
Total	39.5	28.2	10.8

Figure 4

International Reserves
(US$ billion)



depreciated, buying them back when the currency recovered. The bet proved right. The *real* recovered quickly from the 40 per cent fall experienced in late 2008, and stabilized around R$1.8/US$ (*i.e.*, around the exchange rate in 2000). In a few months, international reserves were higher than at the outset of the crisis (Figure 4). By mid 2009, US$ 20 billion of the export credit lines and US$ 8.2 billion of the outright sales, as well as US$ 11 of the currency swaps had been repaid. Almost all the resources had been paid back by 2010.

Ensuring liquidity in the immediate aftermath of Lehman's collapse was essential to avert an unnecessary crisis. In 2005-08, Brazilian companies had lengthened their debt through international bond issues. Nonetheless, in addition to the need of rolling over that debt, external bank credit still accounted for about US$ 97 billion in September 2008, and US$ 47 billion in domestic bank credit were supported by foreign lines. These funds amounted to 20 per cent of the total bank credit market, and the contraction of foreign credit made domestic lending based on foreign funds drop by US$ 38 billion between September 2008 and January 2009. Also, as international capital markets froze, Brazilian companies turned to domestic banks. The most striking case of this dislocation was the R$ 2 billion emergency loan granted by the federal savings bank to Petrobras. A result of this short run financial drying out was a sharp contraction of output in late 2008, as companies cut inventory and put workers on vacation.

The Central Bank channeled liquidity to small banks. In Brazil, small banks depend on funds from large banks, rather than the other way around, as traditionally in the US. As a consequence, they were squeezed when large corporations started to compete for funds from large banks. That had an immediate effect on medium-size companies, which are big employers and depended on smaller banks. In response, the Central Bank reduced reserve requirements by 40 per cent in October 2008, freeing R$ 100 million (3 per cent of GDP, since requirements amounted to 1/3 of

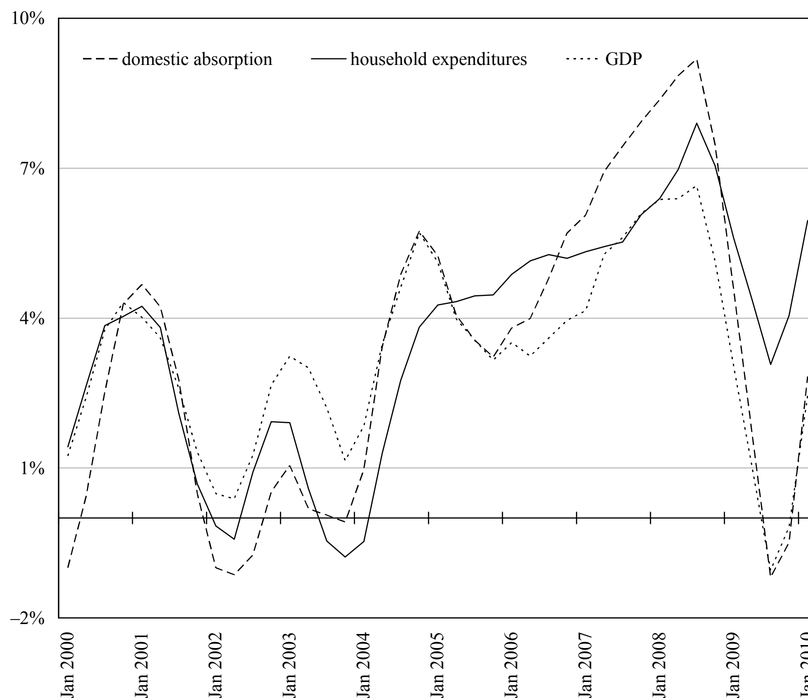
total credit). About half of that was earmarked to re-lending by large banks to small banks or other ways to disperse credit. This re-lending could be insured at government subsidized rates. Most of the remaining freed resources were, however, mopped up by the Central Bank, since private banks did not expand their overall credit in the following months. With the recovery of the economy, requirements were jacked up in early 2010 in the wake of a brisk increase in credit.

Helping smaller banks also supported personal credit. In late 2008, President Lula made a carefully balanced speech on TV prompting workers to continue to spend, except if they already carried large debts. His message was that, as long as a worker did not face a debt overhang, he or she would be better off spending, because this would ultimately help preserve his or her job. Smaller banks were specialized in personal credit, and the intervention of the Central Bank protected this market, which was further stimulated by the entrance of public banks in that segment in the following months.

Although the Central Bank does not make much publicity about

Figure 5

Domestic Demand, GDP Growth and the SELIC Interest Rate



Central Bank SELIC Target Rate
(percent annual rate)

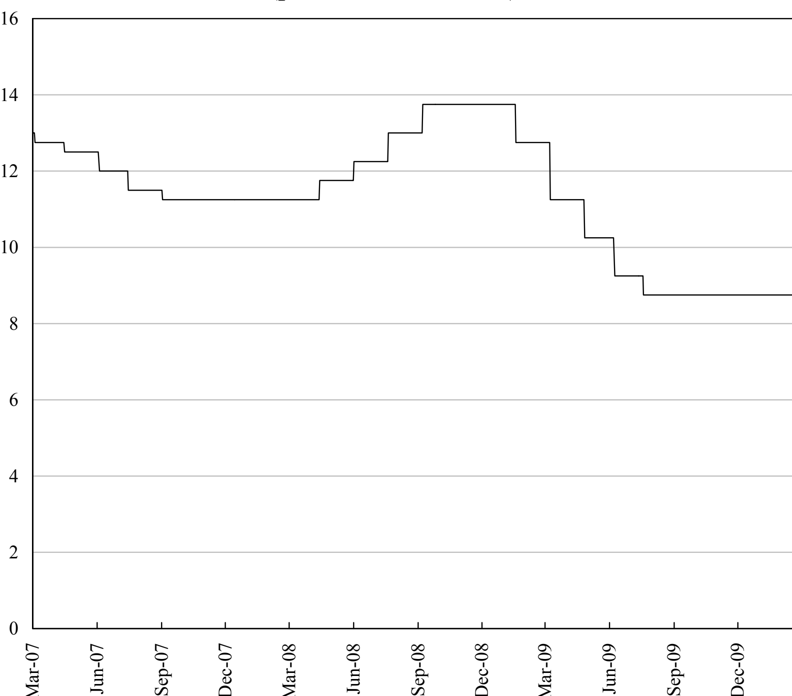
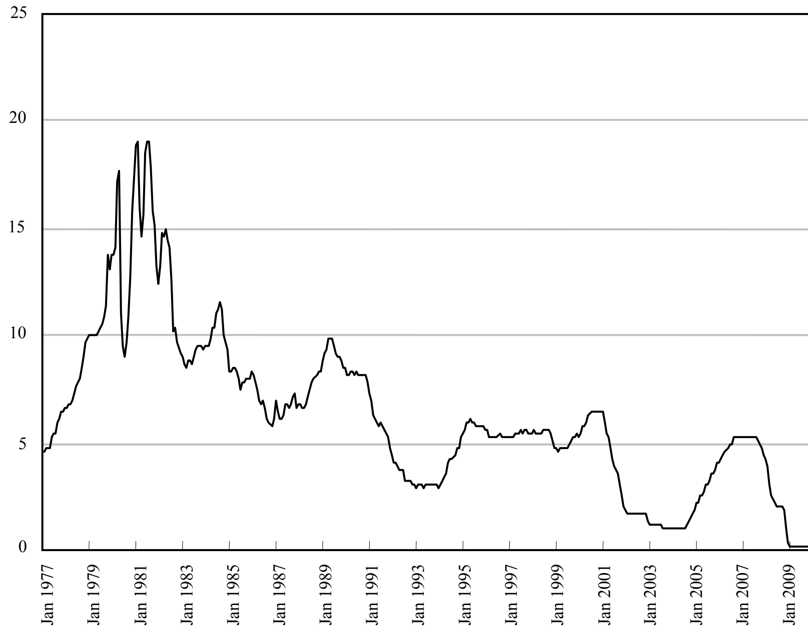


Figure 6

Federal Funds
(percent year)



its role in supporting aggregate demand, interest rates fell to their lowest levels in 15 years. Rates had actually been tightened in 2008, to respond to the impact of record levels of international commodity prices and the over-heating of the economy, which was growing at 6 per cent y-o-y, fueled by domestic demand growth of 9 per cent y-o-y (Figure 5). Between April and September 2008 the Central Bank SELIC rate rose from 11.25 to 13.75 per cent. Rates started to decline only in January 2009, after GDP had contracted close to 2 per cent and inflation expectations were tamed. The SELIC had dropped to 8.75 per cent by July 2009, when the relaxation cycle was complete. It was the first time in recent years that Brazil was able to respond to a slowdown in the world economy by relaxing rather than tightening monetary policy.

The Central Bank was comfortable to reduce rates because of the equilibrium in the domestic economy and the policy response of developed countries to the crisis. The very accommodative monetary policy in the United Stated created unusual liquidity in world markets, stimulating capital flows to Brazil and helping support the exchange rate and reduce inflationary pressure. This is, of course, a scenario radically different from those faced by Brazil in the 1980s, in 1995 (the so-called "Tequila crisis") or in 1998-2001, when capital outflows were the norm, often in the wake of a tightening in the US (Figure 6). It allowed the public sector to adopt a much more ambitious response than in previous crises.

A proactive role for the public sector was illustrated early on by the response to the problems of a handful of exporters caught off guard. As mentioned above, financial markets performed well during the crisis. Nonetheless, there were a few companies that faced very dangerous situations. In particular, two large exporters that had been unhappy with the appreciation trend of the *real* and high domestic interest rates, bought complex derivatives, betting on borrowing at lower interest rates against the risk of a large loss in the case of a major depreciation of the *real*. As the currency swung beyond any expected threshold, the contracts called for extremely punitive payments that exceeded by far the companies' export streams and caused severe cash flow problems. The government response, after checking that this was an idiosyncratic problem, was to induce each of the firms to merge with stronger competitors, with the financial help of the National Bank for Social and Economic Development (BNDES). The strategy chastised controlling shareholders, while striving to preserve ongoing concerns. It was perceived as a portent of opportunities opened by the crisis, for allowing the creation of global powerhouses in the export markets of poultry and cellulose.

The episode of derivatives also highlights strengths of Brazilian financial markets. Authorities could intervene firmly and timely because they had access to information, which included the individual name of final risk bearers of each contract. By inquiring in the clearing system (CETIP) where it is mandatory to register every over the counter contract, the Securities Exchange Commission (CVM) and the Central Bank were able to quickly map the exposure of all domestic derivatives. This stands in striking contrast with, for instance, the US, where authorities would know only the aggregate positions of banks. The review showed Brazilian authorities that large risks were concentrated on exposures of one type of contract offered by foreign banks offshore, facilitating the tailoring of the response. Also, because most companies knew that the Central Bank would not try to defend the currency, they were adequately hedged, requiring minimum liquidity provision to the futures market by the Central Bank.

3.2 Automatic stabilizers

In contrast with most developing countries, Brazil has strong demand stabilizers, anchored on sizeable social transfers. Pay-as-you-go pension payments amount to 9.2 per cent of GDP. About 40 million workers, in a 92 million working force contribute to the general pension system, while 6.5 million are enrolled in schemes for public employees, and 19 million are self employed in and out of the formal market and the roll of social security contributors. The general scheme pays about 23.5 million benefits a month, of which 1/3 referring to rural pensions with tenuous contributory factor. In addition, the social security pays 3.5 million old-age and disability minimum-revenue benefits (LOAS-RMV) amounting to R$ 20 billion. Unemployment insurance, although limited by high rotation and job informality, typically benefits more than 6 million people a year. Also, since the early 2000s, and especially since 2003, the Bolsa Família program has become an important vector for social transfers (before 2003 the program had a different name). By 2008, it reached more than 11 million households (close to 20 per cent of the Brazilian population) with benefits averaging R$ 1000 a year (US$ 50 a month).

All mechanisms of social transfers expanded their payments in 2009, translating into a stimulus of 0.45 per cent of GDP. Social security outlays rose from R$ 199 billion in 2008, to R$ 225 billion (US$ 125 billion) in 2009. This 13 per cent increase was well above inflation or the growth of nominal GDP, reflecting the upward trend in the number of beneficiaries and real increase in benefits linked to the minimum wage. LOAS/RMV outlays increased by 18 per cent (0.07 per cent of GDP), while unemployment insurance payments rose from R$ 21 billion (0.70 per cent of GDP) to R$ 27 billion (0.88 per cent of GDP), with the roll of beneficiaries rising to 7.5 million. On September 2009, the scale of Bolsa Família benefits was increased by 10 per cent, compounding the effect of the expansion of the coverage of the system to 12.4 households. Total expenditure with the program reached R$ 12 billion in 2009, or 0.3 per cent of GDP.

A recent minimum wage setting mechanism helped support demand. The rule agreed in 2007 established that real wage increases should reflect per capita real GDP growth two years before. Confirmed by the decree n. 456/2009, it meant more than 5 per cent real growth for the minimum wage in 2009. The impact of this growth went well beyond formal employees earning the minimum wage for two reasons: pay levels in the informal market are linked to the minimum wage, because the duality of labor markets is related more to the payment of taxes than to wage levels; the floor of pensions and other benefits, comprised in the "broad labor compensation" monitored by the Central Bank, are also linked to it.[2]

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[2] For the Central Bank, "wage" income accounts for 76 per cent of broad labor compensation, while pensions represent 21 per cent and minimum income programs 3 per cent.

3.3 Fiscal measures

Fiscal measures by the central government included reductions in taxes and increases in public servant wages and investment. Tax breaks ranged from the reduction in the federal VAT on industrial goods (IPI), to the introduction of new income tax brackets aimed at reducing the tax burden on the middle class. Also, the tax on the financial transaction IOF on loans and the corporate income tax due by companies involved with a new low-income housing program were cut down. Altogether, the direct fiscal stimulus amounted to about 0.5 per cent of GDP, with the following breakdown: R$ 5 billion (0.2 per cent of GDP) due to the change in income tax brackets; R$ 6 billion out of total IPI revenues of R$ 39 billion in 2008; R$ 2.5 billion related to IOF; R$ 0.2 billion related to the tax break for the real estate sector. The stimulus was effective in some sectors, such as the auto industry and home appliances: car production recovered to a record level of 3.1 million vehicles in 2009, making Brazil the fifth largest auto producer in the world that year.

The increase in public wages outpaced by far the expansion in public investment. Wages in the Executive branch rose by 16 per cent in the Executive branch. Together with an increase in positions, it led the payroll to rise from 4.35 per cent of GDP in 2008 to 4.84 per cent of GDP in 2009. This 0.5 per cent of GDP increase was larger than the combined effect of automatic stabilizers, although it benefited a much smaller group of people. It was also larger than the R$ 11 billion expansion in Central Government investments, notwithstanding the prominence given to projects in the PAC-Growth Accelerating investment program, especially those benefiting from the PPI allowance that excluded certain Central Government investments from the primary target (PPI outlays increased from R$ 7.8 billion to R$ 16 billion).[3] Indeed, despite great managerial effort and absence of fiscal constraints in the case of the PPI, investments by the Central Government amounted to just a bit more than 1.5 per cent of GDP in 2009.

Significant part of the fiscal stimulus was done through public enterprises. Public investments by Eletrobras, the federal electricity holding company, reached R$ 3.6 billion, while the company, often as a minority partner, participates in PAC projects to the top of R$ 41 billion. Petrobras invested R$ 50 billion in the first three quarters of 2009 (1.6 per cent of annual GDP), as part of its US$ 174 billion investment plan for 2009-13. Investment by the federal government and Petrobras accounts for more than 15 per cent of total investment, according with the Ministry of Finance. However, despite its role in the PAC and in the government public agenda, Petrobras has recently been excluded from the fiscal figures of the consolidated public sector, because Brazil adopted the practice used in most developed countries with regard to public enterprises producing market goods. Traditionally, Petrobras contribution to the consolidated public sector primary balance had been in the range of 0.4-0.5 per cent of GDP.

Additional stimulus came from public banks through vigorous credit expansion (Figure 7). Banco do Brasil moved aggressively in retail, in addition to keep its traditional role in farming. It acquired two medium-size banks, one in a rescue operation and the other put for sale by a state government. Banco do Brasil took full advantage of lower interest rates and the acquisitions to increase its consolidated lending by 33 per cent in 2009. The savings bank Caixa Econômica Federal (CEF) expanded its credit by more than 50 per cent, increasing its market share by 2.3 percentage points to 8.8 per cent, in a expanding market. The balance sheet of BNDES more than doubled *vis-à-vis* 2007, with large exposures to private and public companies, in support of outright investments as well as several mergers and acquisitions. Disbursements totaled R$136

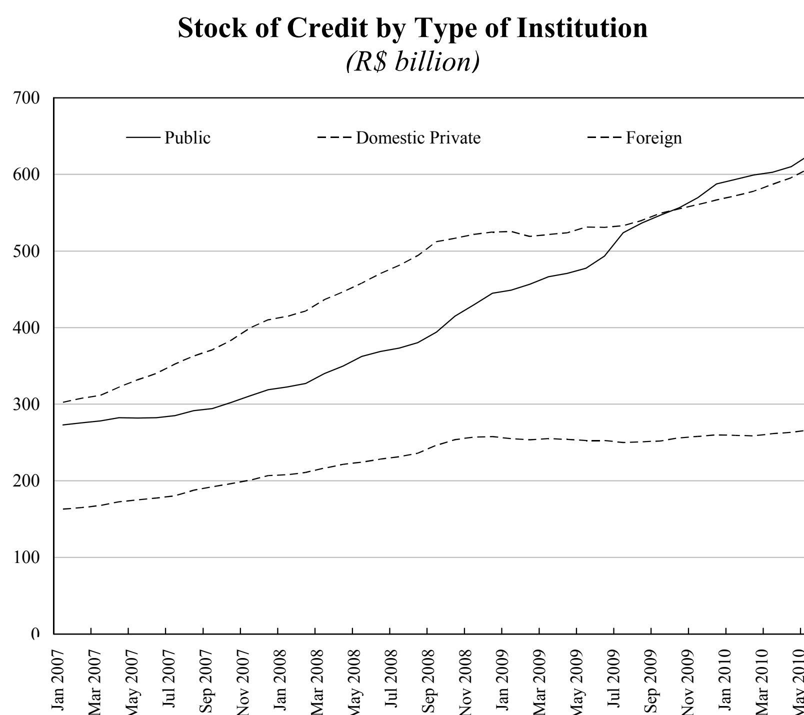
[3] The PPI was introduced in 2005 as a pilot project in which investments with ascertained rates of return would be excluded from the fiscal targets under the argument that the country was not facing a liquidity constraint anymore and therefore fiscal targets should focus on solvency. As such, if an investment could bring more in the long run than the cost of financing it, it was worth doing as long as this financing were available. At the beginning the PPI allowance amounted to R$ 3 billion a year, with the possibility of replacing projects that did not perform adequately with new ones.

billion in 2009 (≈US$ 75 billion), against R$91 billion in 2008 and R$65 billion in 2007 (*i.e.*, +2 per cent of GDP). With credit expansion by private banks modest for most of 2009, the share of public banks in total credit rose from 34.8 per cent in late 2008 to 42 per cent by the end of 2009.

Figure 7

Stock of Credit by Type of Institution

(R$ billion)



Abundant credit also propped up a new housing program and helped buffer states against the decline in federal transfers. The "minha casa-minha vida" low-income housing program was set up to provide R$ 6 billion in subsidized loans to developers and households. Although disbursements were negligible in 2009, projects for 275 thousand houses were approved, creating great expectations in the construction sector, which had not benefited from significant public funds since the 1980s, when macroeconomic instability led to the bankruptcy of the existing financing system (BNH).[4] The federal government also offered about R$ 2 billion in loans from public banks to states facing shortfalls in VAT receipts and lower federal transfers, and lifted their borrowing ceilings by R$ 10 billion, facilitating loans from multilateral financial institutions.

On balance, the crisis strengthened the presence of public companies, which was already significant, especially in energy and banking. Petrobras is dominant in domestic oil and gas production, virtually a monopolist in refining and an important player in fuel distribution. Its sales reached R$ 232 billion in 2008, for a market cap of US$ 97 billion (Total's and Eni's market caps were of US$ 128 billion and U$ 93 billion respectively, in December 2008). Sales of Eletrobras summed R$ 32 billion in 2008. The company controls 38 per cent of electricity generation and 56 per cent of transmission, with more than 40 thousand miles of transmission lines. Banco do Brasil was the largest bank prior to the merger of Itau and Unibanco and its profits reached a record level of R$ 10.1 billion in 2009 – the largest ever for any Brazilian bank. CEF is also among the largest five or six banks, but its profits fell by 22 per cent in 2009, while those of private banks rose on average by 24 per cent that year. BNDES annual lending nowadays exceeds by far that of the World Bank.

4 Remaining risks and structural issues

The success in responding to the crisis highlights the importance of fiscal issues in Brazil and

[4] The resulting bad loans remained in the financial sector until 2001, when they were moved to the resolution company EMGEA.

of further reforms to consolidate the gains obtained in the last 15 years. The response brought fiscal risks that go beyond the decline in the primary surplus of the central government in 2009. These risks may be more related to the belief that the success of the fiscal stimulus and credit relaxation during the crisis vindicates a larger permanent role for the public sector, rather than being an evidence that years of effort allowed the country to successfully deploy countercyclical measures, which were supported by the exceptional combination of lax monetary policy in developed countries and sustained demand in China. Diverse perceptions of the meaning of the quick recovery can thus lead to different policy choices in coming years. These could favor demand stimulus and increased reliance on public companies as the way to long-term growth, or could keep the emphasis on promoting additional structural changes through institutions and the fostering of competition in a free-market economy. They will also be instrumental to reach the long yearned goal of lower interest rates. The decline in interst rates, if correctly done, could unleash a new wave of investments. If forced inappropriately, it could lead to capital flight and stagnation. The following paragraphs review the economic outlook and risks in Brazil, and suggest a direction for a new generation of reforms that may help achieve those goals safely.

4.1 Economic outlook and risks

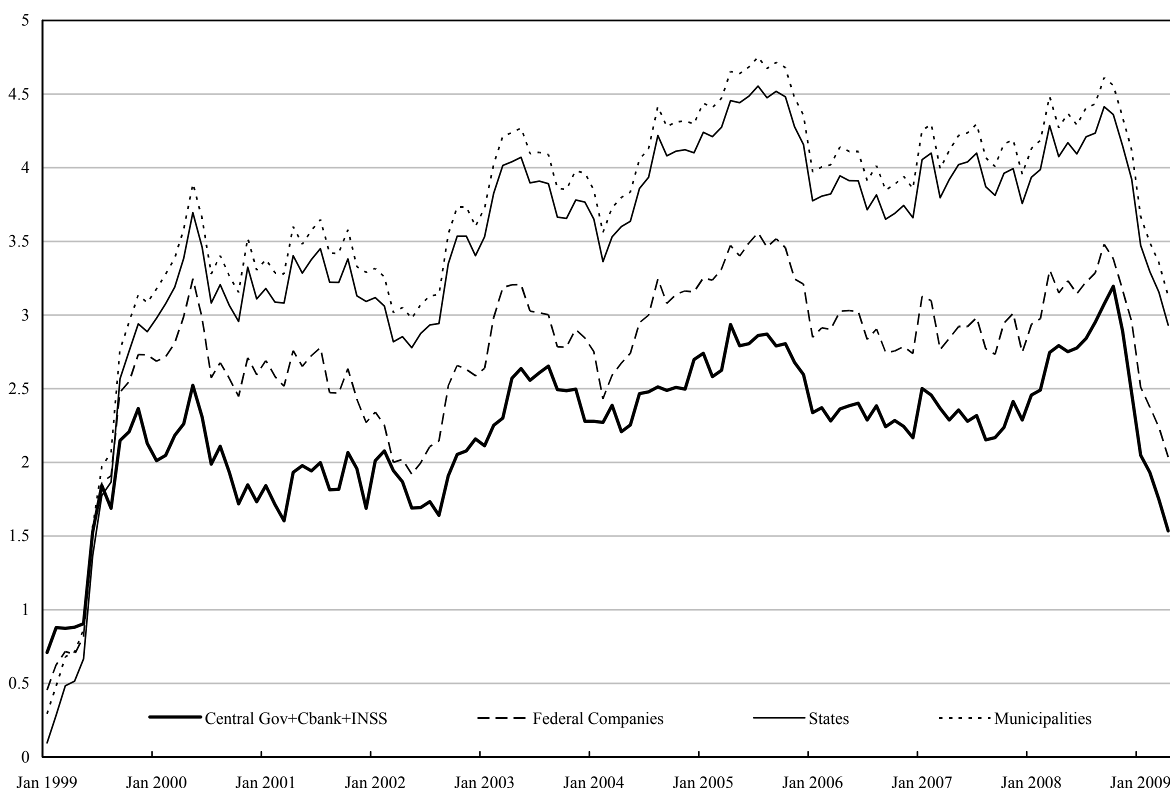
The recovery was unmistakable by the end of 2009, and output is likely to be well beyond potential by end 2010. Retail sales were 8.8 per cent higher at end 2009 *vis-à-vis* one year before; a few months later, industrial production had also regained the lost ground, pulled mostly by domestic demand. Industrial capacity utilization reached record level in 2010, while unemployment was 5 percentage points below its level at the beginning of the growth cycle in 2004, at around 7 per cent. Investment also started to pick up, reaching 19 per cent of GDP in early 2010. By the beginning of the year, the Central Bank started underscoring signs of inflationary pressures, leading to a 1.5 per cent increase in rates by mid 2010, with further tightening likely to be pursued, given the 9 per cent y-o-y GDP growth in the first quarter of the year, an average of up to 250,000 new jobs a month, and inflation in the service sector close to 10 per cent.

Improvement in fiscal accounts in 2010 will be due mostly to the buoyancy of the economy, as in 2008. The deterioration of the primary surplus in 2009 suggests an important break with early Lula years, even considering cyclical factors. Indeed, fiscal discipline begun to weaken before the crisis, although that was masked by the upswing of the economy. The phasing out of the CPMF contribution on bank transactions in December 2007 implied a permanent loss of R$ 40 billion in revenues (1.5 per cent of GDP), which was temporally offset by the extraordinary buoyancy of the income tax in 2008, pushed by profits from banks and the general acceleration of GDP (the income tax rose 19 per cent from 2007 to 2008, accounting for R$ 30 billion in additional revenue). With the economic slowdown, those weaknesses became apparent, and were compounded by a change in the command of the Revenue Service in August 2008 that brought ill-timed and ineffective innovations, which eventually led to the replacement of the team a year later. With the recovery, tax receipts have increased (sometimes with the help of once-off measures), improving fiscal outcomes. Nonetheless, primary results remain erratic, and expenditure remains the real problem. Central Government outlays, excluding transfers to sub-national governments, rose by 15 per cent in nominal terms in 2009 (+10 per cent real, or 2 percentage points of GDP), and Government and Congress have brought new decisions on pensions and public-sector wage increases in 2010 that only exacerbate the problem.

It is important to continue to watch primary results and debt levels. The primary surplus of the central government halved in 2009, dropping to 1.25 per cent of GDP (Figure 8). It may improve in 2010, but targets for 2011 include so many allowances for special items, that they are losing their meaning. Also, beyond Central Government primary spending, the expansion of the BNDES balance

Figure 8

Primary Balance of the General Government
(percent of GDP)

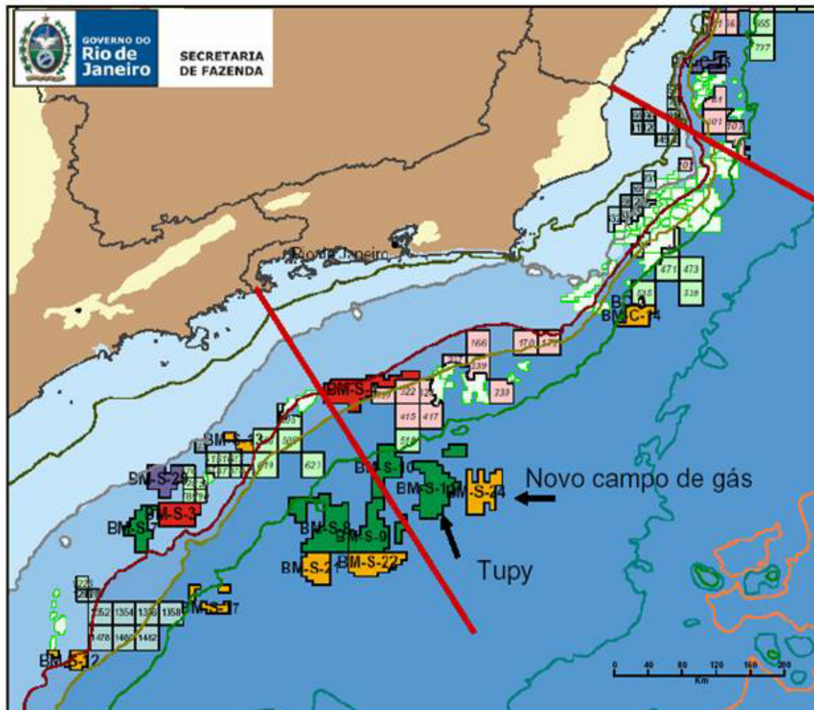


sheet raises flags: most constraints on lending to public companies imposed in the 1990s and early 2000s were lifted, while large exposures to private companies over a broad range of sectors were built. Abstracting from legitimate views on industrial policy, these actions have a clear fiscal bias, because they required extensive support from the National Treasury and brought back a practice of money-creation that had been stopped in the 1980s. Although the increase in the Treasury exposure did not affect the non-financial public sector net debt figures, because it was effected trough the purchase of BNDES subordinated debt rather than outright capital injections, it impacted gross debt. Of the R$ 233 billion increase in the National Treasury gross debt in 2009 (+15 per cent, or 5 per cent of GDP), R$ 102 billion (3 per cent of GDP) arose from the financing of public banks.

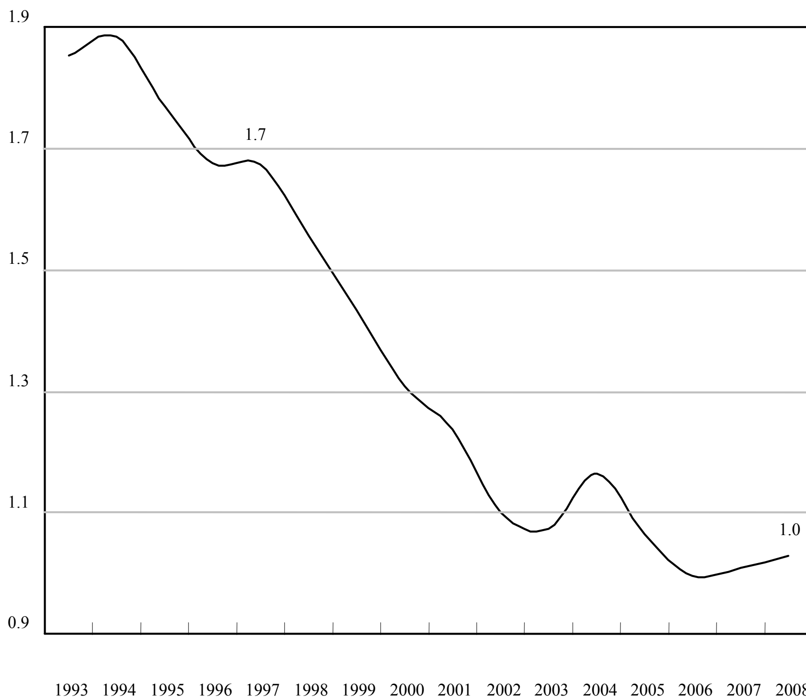
Public spending will keep the pressure on the external accounts. The strong pace of household consumption, fueled by fiscal and credit policies, as well as a sharp increase in profit and dividend remittances, has created a current account deficit. This increase appears to be related to financial needs of international companies rather than to any weakness in the Brazilian economy, as it has been contemporary to higher foreign direct investment inflows and reserves levels (the BOP showed a US$ 46 billion surplus in 2009, with a financial account surplus of US$ 70 billion). Nonetheless, risks may be accumulating, considering that imports have doubled in quantum since 2006, while the quantum of exports has remained stable. More than half of the increase in exports receipts in the last five years is owed to price increases, while import prices have been very tame. A change in the terms of trade, often contemporary with a global increase in interest rates, could require an important adjustment in the economy. Past experience and the dynamics of imports

Figure 9

Energy Independence and the "Pré-sal" Oil Province Off-shore Rio de Janeiro



Oil Consuption/Production



Source: ANP.

during the crisis suggest that this adjustment is feasible, if not painless. A large part of imports refers to intermediate goods, and their weight floats with the exchange rate and other relative prices, owing to the ability of the diversified domestic industrial basis to supply these items when prices are attractive. The increase in the import content of local manufacturing, as well as in the share of commodities in total exports, has not necessarily implied a hollowing of the Brazilian industry.

On the bright side, Brazil can count on new oil discoveries and a steady demand from China. Brazil can be a reliable long-term supplier of minerals, food, construction materials and basic industrial goods to China. With regard to oil, the reserves in the "pré-sal" province are in the 50-80 billion barrels range (Figure 9). Production there could reach 2 million barrels a day by 2017. Most of this oil would be available for exports, generating up to US$ 50 billion a year in income (1-2 per cent of GDP). In addition, minimum domestic content requirements on equipments and services supplied to oil companies in the pré-sal will have a multiplier effect,

remembering that a third of the annual R$ 80 billion investment program of Petrobras is linked to the drilling and production of oil. The expertise and scale local suppliers will obtain by servicing the pré-sal will likely help create new streams of exports. The challenge will be to walk the fine line between industrial promotion and inefficiency.

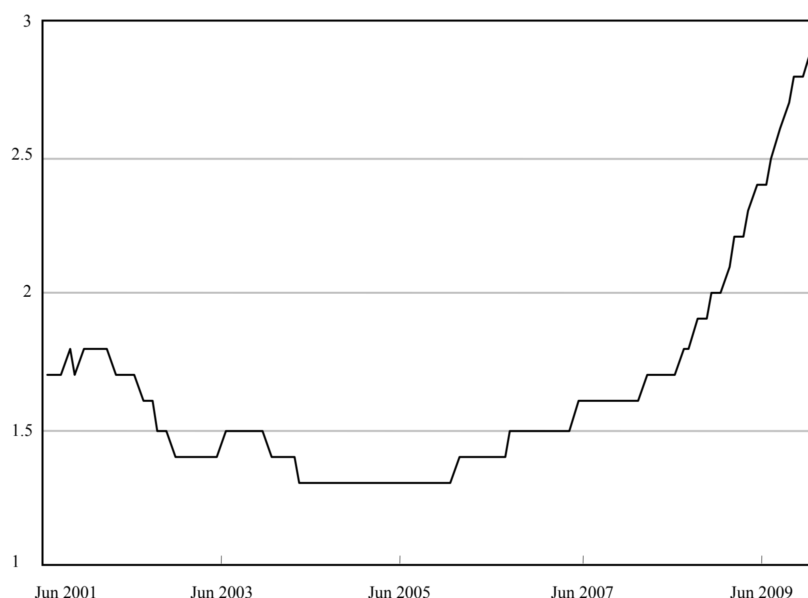
4.2 The scope for further structural reforms

Reforms adopted since 2003 have proved effective, as demonstrated by the expansion in real estate investment since 2005. First-generation reforms from the 1990s (e.g., in oil drilling, telecomm, banking) yielded benefits throughout the 2000s. These, have increasingly been accompanied by those from a second generation of reforms implemented after 2003 (Table 4). One of the most effective reforms in the latter group was the one dealing with real estate. This project-finance inspired reform segregated real estate projects against developers' corporate bankruptcy and other risks, providing much more security to buyers and financers.[5] Coupled with the relaxation of monetary policy and earlier changes in lending rules (e.g., strengthening of repossession of financed houses), it unlocked a huge market, reviving the construction sector even before the "minha casa-minha vida". New house financing rose from 30,000 in the 1990s and early 2000s, to 300,000 more recently, supporting several IPOs of developers. The market is still small, with annual disbursements of just R$ 30 billion, and the stock of mortgages amounting to just around R$ 105 billion (*i.e.*, 3 per cent of GDP), but its potential is large (Figure 10).[6]

Medium-term fiscal spending targets, together with third-generation reforms can reduce aggregate risks, stimulating idiosyncratic risks and investments. Such spending targets would help agents to assess the impact of fiscal impulses to the aggregate demand and the amount of distortion caused by future taxes. It would thus be a natural improvement over the existing commitment to the primary surplus target. Third-generation reforms could focus on the refinement of existing check-and-balance systems, strengthening

Figure 10

Real Estate Lending – Stock of Residential Loans
(percent of GDP)



5 In the 1990s many individual investors lost money because constructors would mix resources from several projects in a common account. Because tax and labor liabilities would have precedence in any bankruptcy situation, problems in one project would quickly affect all projects.

6 The stock is so small also because the residual, unfunded mortgages from the 1970-90 have been transferred to the resolution fund EMGEA.

Table 4

The Reform Agenda Accomplished in the Early Years of the Lula Administration

Law	Topic	Effect
No. 10820/2003	Loans guaranteed by payroll	Lowers cost of personal loans
No. 10833/2003	Makes pis-cofins non cumulative	Reduces distortion of this federal tax
No. 10931/2004	Reforms real estate sector, segregating projects for tax and bankruptcy purposes	Reduces risks for builders and buyers
No. 11079/2004	Introduces PPP	
No. 11101/2004	Bankruptcy law	Changes payment priorities, promotes resale of assets and preservation of concern
No. 11196/2005	Incentives to R&D	Provides tax brakes and stimulus for diffusion of innovations
LC 123/2006	Small enterprises	Consolidates their tax liabilities, reducing overall tax burden to foster formalization
LC 126/2006	Opens re-insurance market	Ends monopoly and opens market to domestic and foreign companies
No. 11445/2006	Sanitation Framework Law	Regulates concessions in the sector
No. 11638/2007	Corporations Law	Subjects accounting rules to control of independent bodies, aligning them with international practice

regulatory agencies and external control of government decisions. This would respond to the want of better coordination among agencies representing stakeholders that often unduly increase the risk surrounding private and public investment and help improve the effectiveness of public spending. It would, for instance, address the incentives for agencies responsible for licenses to procrastinate, rather than give positive or negative responses; or the problem that obtaining a stay from a court (mandado de segurança) is rather easy, while deciding on the merit can drag for decades. Improving the governance of macro-processes in the public sector needs not hamper freedom or growth, but rather make rules more clear and objective. Absent that, the tendency would be a sliding towards bullying agencies and the return to discretionary and unaccountable polices from the Executive branch and close-door decisions by public companies.

That two-pronged approach could pave the way to lower interest rates. Although rates are below the peaks of the 1990s or early 2000s, they remain surprisingly high, distorting investment and labor decisions and creating incentives for rent seeking, such as below-market rate loans from BNDES. A frontloaded effort in the fiscal would thus reduce the implicit subsidy in BNDES loans, which, at R$ 10 billion, adds up to almost the cost of the Bolsa Família.[7] It would also help shave government interest payments, which are in excess of 5 per cent of GDP, freeing resources ahead. It is intuitive that the current policy mix of tight monetary policy and expanding fiscal policy is inefficient in an environment where growth quickly translates into price increases because fiscal uncertainty weakens the supply response to shocks in aggregate demand, and large companies borrowing from BNDES are insulated from Central Bank rates. Hence, the good financial

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[7] This amount is estimating considering a 5 per cent subsidy on a R$ 200 billion balance sheet.

indicators currently surrounding the public debt should not be mistaken for a license to spend, even if credit default swaps on Brazilian debts are priced below those on Italy and Spain (e.g., CDS premium of 131 bps for Brazil, versus around 180-240 for those countries). A balanced and sound decline in rates would strengthen Brazilian companies on the whole and probably reduce the need for the government to promote "national champions" through official channels, as well as the incentive for firms to share risks with the government through loans from public banks.

Sub-national governments provide interesting experiences regarding better quality in public spending. An often overlooked consequence of the institutional changes triggered by price stability was the pressure on subnational governments to focus on better service delivery. Without the smoke of inflation, subject to the Fiscal Responsibility Law, and with little room to issue debt, state governments changed their way to do business, focusing on core areas such as health, education and public security, which are essential to long-term growth. Increased commitment to transparency, stronger compliance rules, and better internal controls were promoted, together with more effective rapports with controlling agencies.[8] New, ambitious programs for automating and integrating taxes, spending and their accounting using corporate systems (e.g., SAP/Oracle ERPs) are also under way.

Given the excellent financial infrastructure of Brazil, further confidence on fiscal and macroeconomic balances could facilitate the tapping of local capital markets. Clearing, custody, as well as trading and underwriting technology and systems are state of the art in Brazil. The Brazilian Exchange BOVESPA is one of the four most valuable exchanges in the world, and the overall market capitalization of listed companies is at par with that of Spain and Germany. Over the counter clearing institutions are also nimble and secure. Pension funds, investment funds, and insurance companies have thrived since the reforms of the early 2000s, creating a robust and increasingly well regulated sector of institutional investors eager to find new outlets for their savings. Thus, the share of capital market debt in the balance sheet of industries doubled in 2006-07 and amounted to 8 per cent of GDP in 2008, while bank loans excluding those using earmarked/public funds have stagnated. With less aggregate risk and the ensuing lower interest rates, the BOVESPA plan to list up to 200 new companies in the coming years could become reality and dramatically facilitate the financing of corporations and infrastructure, sustaining growth.

5 Concluding remarks

The success of the response to the crisis validates the policy choices of the last 15 years. The success in deploying anti-cyclical instruments should not be confused with a license to weaken the fiscal stance in the medium term and expand public companies in a thoughtless way, but rather be seen as a sign of the potential of third-generation reforms. Sedimentation is one of the strengths of Brazil, which helped consolidate the reforms of the 1990s and promote a new round of changes in 2003-06, all along boosting the confidence in the policy formulation and implementation process. This cycle should be extended in the aftermath of the 2008 crisis, through the elimination of any doubts about the country's solvency. This would be especially favorable to growth, considering the new opportunities opened up by the pré-sal oil discoveries, long-term trends in international trade and capital flows, as well as the large market driven by a burgeoning middle class. Discipline on pubic financing of banks should not be weakened, in light of past experiences

[8] In Rio de Janeiro, oil revenues, for instance, are channeled to the public servants pension fund, insulating the rest of the government from the fluctuations in oil prices, and guaranteeing great transparency in the use of these receipts. Better governance has also helped the nature conservancy fund FECAM financed with a small share of those oil revenues to deliver consistent results, with lower agency costs. Also, on-line disclosure of every payment and other measures to improve transparency and predictability have allowed the government to expand partnerships with the private sector and lower acquisition costs significantly.

and of the vitality of domestic capital markets. Instead, the focus should be on improving the quality of public spending and regulatory agencies, and on developing a new framework to reinforce instances of social control, to foster accountability without unduly slowing down investment projects. Confidence in the fiscal outlook, together with yet more clarity on the functioning of institutions, would help avoid overlapping demands from licensing bodies and stimulate greater use of capital markets, fostering investment and growth.

APPENDIX

Table 5

Gross and Net Debt of the General Government of Brazil

Item	*R$ million*				*2009/08 percent change*	*percent of GDP*			
	2006	2007	2008	2009		2006	2007	2008	2009
Net debt of General Government (C+F+I+J)	**1,091,255**	**1,181,418**	**1,175,203**	**1,378,129**	**17.3%**	**46.0**	**44.4**	**39.1**	**44.0**
Gross Debt of General Government (C=D+E)	**1,336,645**	**1,542,852**	**1,740,888**	**1,973,424**	**13.4%**	**56.4**	**58.0**	**57.9**	**62.9**
Domestic Debt (D)	**1,186,058**	**1,426,087**	**1,595,878**	**1,861,984**	**16.7%**	**50.0**	**53.6**	**53.1**	**59.4**
Treasury Bonds and Notes	1,073,652	1,204,314	1,236,732	1,369,262	10.7%	45.3	45.3	41.2	43.7
Open Market BCB Operations	77,367	187,416	325,155	454,710	39.8%	3.3	7.0	10.8	14.5
Federal Government Loans	2,090	2,216	2,103	2,262	7.6%	0.1	0.1	0.1	0.1
Liabilities to CEF – Law 8,727/1993	23,585	22,194	20,358	17,630	–13.4%	1.0	0.8	0.7	0.6
State Loans	6,339	6,425	7,276	12,546	72.4%	0.3	0.2	0.2	0.4
Municipal Loans	2,890	3,371	4,253	5,574	31.1%	0.1	0.1	0.1	0.2
External Debt (E)	**150,587**	**116,764**	**145,010**	**111,440**	**–23.2%**	**6.4**	**4.4**	**4.8**	**3.6**
Federal Government	136,108	104,433	126,456	94,993	–24.9%	5.7	3.9	4.2	3.0
State Governments	12,545	10,641	16,054	14,440	–10.1%	0.5	0.4	0.5	0.5
Municipal Governments	1,934	1,691	2,500	2,007	–19.7%	0.1	0.1	0.1	0.1
Claims of the General Government (F=G+H)	**–465,221**	**–533,018**	**–563,425**	**–830,612**	**47.4%**	**–19.6**	**–20.0**	**–18.8**	**–26.5**
Domestic Credits (G)	**–465,221**	**–533,018**	**–563,425**	**–830,612**	**47.4%**	**–19.6**	**–20.0**	**–18.8**	**–26.5**
Short Term Assets of the General Government	–247,406	–305,568	–292,507	–445,177	52.2%	–10.4	–11.5	–9.7	–14.2
Cash	–5,528	–7,072	–8,351	–7,746	–7.2%	–0.2	–0.3	–0.3	–0.2
Claims against the BCB	–226,047	–275,843	–255,217	–406,354	59.2%	–9.5	–10.4	–8.5	–13.0
State claims against banks	–14,396	–21,358	–25,993	–29,252	12.5%	–0.6	–0.8	–0.9	–0.9
Loans to official institutions	–12,343	–14,150	–43,087	–144,787	236.0%	–0.5	–0.5	–1.4	–4.6
Subordinated debt	–2,389	–7,504	–7,633	–15,550	103.7%	–0.1	–0.3	–0.3	–0.5
Claims against BNDES	–9,953	–6,645	–35,454	–129,237	264.5%	–0.4	–0.2	–1.2	–4.1
Assets of funds and programs	–50,294	–54,790	–61,700	–73,851	19.7%	–2.1	–2.1	–2.1	–2.4
Claims against SOEs	–20,041	–18,805	–18,977	–16,518	–13.0%	–0.8	–0.7	–0.6	–0.5
Other claims	–12,487	–11,289	–10,974	–10,249	–6.6%	–0.5	–0,4	–0.4	–0.3
Claims of FAT against banks (mostly BNDES)	–122,650	–128,417	–136,181	–140,030	2.8%	–5.2	–4,8	–4.5	–4.5
External Assets (H)	**0**	**0**	**0**	**0**	**-**	**0.0**	**0.0**	**0.0**	**0.0**
Federal bonds owned by BCB (I)	**219,831**	**171,585**	**169,156**	**183,105**	**8.2%**	**9.3**	**6.4**	**5.6**	**5.8**
Revenues from currency derivatives (J)	**0**	**0**	**–171,416**	**52,212**	**–130.5%**	**0.0**	**0.0**	**–5.7**	**1.7**
Memo Items									
BCB Net Debt	**8,481**	**8,585**	**–31,922**	**–39,189**	**22.8%**	**0.4**	**0.3**	**–1.1**	**–1.3**
Net Debt of SOEs (excludes Petrobras)	**12,965**	**10,795**	**10,351**	**6,385**	**–38.3%**	**0.5**	**0.4**	**0.3**	**0.2**
GDP 12month, deflated by the IGP-DI	2,369,797	2,661,344	3,004,881	3,135,010	4.3%				

Table 6

Balance of Payments
(US$ million)

Item	2004	2005	2006	2007	2008	2008 Jan-Oct	2009 Jan-Oct
Trade Balance	33,641	44,703	46,458	40,032	24,836	20,920	22,641
Current Account	11,679	13,985	13,621	1,550	–28,192	–24,122	–14,788
Capital Account	372	663	869	756	1,055	906	888
Financial Account	–7,895	–10,127	15,113	88,330	28,297	44,126	51,317
Foreign Direct Investment	8,339	12,550	–9,420	27,518	24,601	19,121	24,311
Outward	–9,807	–2,517	–28,202	–7,067	–20,457	–15,647	5,058
Inward	18,146	15,066	18,782	34,585	45,058	34,768	19,254
Portfolio Investment	–4,750	4,885	9,573	48,390	1,133	9,598	39,331
Stock	–3,875	7486	9,966	49,517	–1,024	9,008	40,040
Fixed Income	2,714	7391	6,278	24,518	–9,208	–5,324	31,970
Other Investments	–10,806	–27,521	14,577	13,132	2,875	15,751	–12,494
Errors and Omissions	–1,912	–201	965	–3,152	1,809	–5,560	881
BALANCE OF PAYMENTS	2,244	4,319	30,569	87,484	2,969	15,350	38,298
Memo:							
Current Account/GDP	1.76	1.58	1.25	0.12	–1.79	–1.83	–1.26